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IN THE

Supreme Court of the United States

OCTOBER TERM, 1933.

No. 158

DAVID BURNET, COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

vs.

CHARLES J. CANFIELD.

REPLY BRIEF OF CHARLES J. CANFIELD TO THE PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SEVENTH CIRCUIT.

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OPINIONS BELOW.

The opinion of the Board of Tax Appeals is reported in 24 B. T. A. 480. The opinion of the Circuit Court of Appeals is reported in 62 Fed. (2d) 751 and is reprinted in the record at page 42.

THE FACTS.

The facts are summarily set forth at pages 3 and 4 of the petition for the writ. There is no incorrect statement therein of importance, but it adds something to a clear perception of the issue to set out the actual profits and losses for the period beginning March 1, 1913, and ending April 14, 1923. They were as follows:

Year Ending	Profits	Losses
February 28, 1914.....	$ 4,594.62	
February 28, 1915.....		$193,139.67
February 29, 1916.....		211,707.32
February 28, 1917.....	60,495.56	
February 28, 1918.....	57,901.55	
February 28, 1919.....	208,737.34	
February 29, 1920.....	543,490.33	
February 28, 1921.....	640,837.43	
February 28, 1922.....	182,954.63	
February 28, 1923.....	718,858.29	
March 1, 1923, to April 14, 1923 (44/366 of $311,209.54)	37,413.17	
Totals	$2,455,282.92	$404,846.99

The difference between such totals is $2,050,435.93. The undistributed net balance arising out of 1913-1923 operations was thus, as of April 14, 1923, $760,435.93, which is, of course, the exact amount of the excess in the surplus of that date over the surplus of March 1, 1913.

The issue is whether that addition to surplus constituted on April 14, 1923, the undistributed "earnings or profits accumulated since February 28, 1913,"

within the meaning of Section 201 (a) of the Revenue Act of 1921, or whether the total of the profits of the several years from *March 1, 1916,* to April 14, 1923, viz., $1,160,658.30 (without deduction of the losses of $193,139.67 and $211,707.32 incurred in the years ending February 28, 1915, and February 29, 1916) constituted on April 14, 1923, such undistributed earnings or profits "accumulated *since February 28, 1913.*"

Reasons for Granting the Writ.

The Commissioner has given two reasons for granting the writ of certiorari in this case.

A.

The first (p. 5) is that there is a conflict between the decision in this case and the decision in the case of *William R. Thorsen* v. *Commissioner,* decided May 19, 1933, in the Ninth Circuit. This is true.

The Commissioner says further that the decision herein below "is believed to be in conflict with that of the Court of Claims in *Blair* v. *United States,*" 63 Ct. of Claims 193. This is incorrect. In the Blair case there was no surplus on March 1, 1913, and therefore the case is not in point. The very brief opinion stated that the corporation therein involved had "a loss in excess of its gains *for the period of its corporate existence,* as well as for the period from March 1, 1918 (evidently a misprint for 1913, as it had a profit of $84,868.39 for the period March 1, 1918, to December 31, 1918; see Finding of Fact 10.) to December 31, 1918." Finding of Fact 10 made by the court shows a net loss from March 1, 1913, to December 31, 1918,

of $21,194.40. The Commissioner claimed a March 1, 1913, surplus of $106,460.51 (due to his treatment of an item of $546,460.51 of surrendered bonds and coupons). But for these bonds and coupons, there was a capital deficit on March 1, 1913, of $440,000. To satisfy the conditions, therefore, of the court's statement of a corporation with "a loss in excess of its gains for the period of its corporate existence" there could not have been a surplus up to March 1, 1913, of more than the $21,194.40 loss after that date—and that is not what the Commissioner claimed as a surplus.

It is therefore evident that the court treated the case as one with a capital deficit of $440,000 on March 1, 1913, a further (operating) deficit of $21,-194.40 for the period March 1, 1913, to December 1, 1918, and an operating profit in the calendar year 1918 of $84,868.39, from which the dividend of $80,-000 was paid in December, 1913. The court said: "It was a distribution of earnings and profits in 1918." In consequence, as there was no surplus whatever on March 1, 1913, but instead a large deficit, *Blair* v. *Commissioner* does not at all involve the principle in the case at bar, which concerns the proper treatment of a *surplus* existing on that date. Also the Blair case arose under the 1918 Act while this arises under the 1921 Act and the two Acts are radically different. There is no conflict between the decision in the Canfield case and the decision in the Blair case.

B.

The second reason for granting certiorari given by the Commissioner (p. 6) is that the decision of the court below herein is unsound. This point is not

valid. To the contrary, it is submitted that the decision below is indubitably right. It is the decision in the Thorsen case on which the Commissioner relies that is wrong.

1. The only authority anywhere in the 1921 Act to tax dividends in the hands of the recipient is found in Section 201 (a). That section taxes "any distribution made by a corporation to its shareholders or members * * * out of its earnings or profits *accumulated since February 28, 1913.*" No other dividends are taxable. The section involves no element of exemption of certain dividends from the tax imposed by any other provision of the act, as asserted by the Commissioner's brief, page 6. It merely specified what dividends *are* taxed. The burden, therefore rests on the Commissioner to show that the distribution in question was from such profits so accumulated. Otherwise they are non-taxable. The act creates two periods breaking on March 1, 1913. The accumulated earnings prior to that date are non-taxable and the earnings accumulated and distributed after that date are taxed.

2. The Commissioner claims that the earnings for the period of *March 1, 1916,* to April 14, 1923, are the accumulated earnings for the period of *March 1, 1913,* to April 14, 1923, which the statute has created. He wholly excludes from the reckoning the period of March 1, 1913, to March 1, 1916, without any statutory authority therefor, inasmuch as such last named period is included in and is a part of the larger period "since February 28, 1913," named by the act as the period the accumulations of which are taxed. In short, he has segregated a portion of the period and the earnings thereof as though thereby he were measuring the accumulations of the

entire period. As the tax is levied upon the profits accumulated in a specified period *as such,* the entire period and not the several years composing it or any fractional part of the period, is the unit of computation.

3. The only amount that the corporation can be said to have *"accumulated"* since February 28, 1913," is the net of its operations since that date. It cannot be said to have accumulated the totalled profits of certain years within that period without regard to loss years within it. It will have accumulated in a given year the net *of that year,* but for the *period* (covering over ten years) it accumulated not these several nets added together, but that total minus its losses in the loss years of the period. Otherwise, in effect, the words "profits accumulated since February 28, 1913," are stricken from the act. This computation gives the exact figure which the court below held to be correct. Thus the surplus of March, 1913, is left intact and is distributable tax-free.

4. The foregoing approach to the problem exactly co-ordinates with the result arrived at by considering the nature of the surplus of the first period.

5. This court has repeatedly* spoken of the surplus of March 1, 1913, as "capital for the purposes of the act." Capital is not taxable upon distribution. If it be temporarily impaired, it may always be replaced from subsequent earnings. Upon replacement, it is then distributable, as before, tax-

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**Southern Pacific Co.* v. *Lowe*, 247 U. S. 330, 62 L. Ed. 1142, 38 S. Ct. 540; *Gulf Oil Corporation* v. *Lewellyn*, 248 U. S. 71, 63 L. Ed. 133, 39 S. Ct. 35; *Lucas* v. *Alexander*, 279 U. S. 573, 73 L. Ed. 851, 49 S. Ct. 426; *Old Colony Railroad Company* v. *Commissioner*, 284 U. S. 552, 76 L. Ed. 484, 52 S. Ct. 211.

free. This mode of approach arrives at the same result as that reached by interpreting the words "accumulated since February 28, 1913"—that the only taxable distribution is that of the net of the second period.

6. The Act of 1921 therefore taxed to the recipient Canfield only his share of the net of the period "since February 28, 1913," and left inviolate for distribution to him his share of the surplus of March 1, 1913—made "capital, not income, for the purposes of the act."

7. The Commissioner's brief, page 7, asserts that the decision below "ignores the accepted principles of accounting and and the actualities of the situation." This is not the fact. The statute by creating two separate periods, one tax-free and the other subject to tax, requires the setting up of two separate profit and loss accounts, whereas the Commissioner in violation of correct principles of accounting merges the two.

Nor does the position of the court ignore actualities. There is nothing in the record to show that West Side Lumber Company could in fact have distributed instanter, $4,332,684.78 of its total assets of $5,833,684.78. This would have required a 74 per cent liquid position—one scarcely to be anticipated for any corporation, and in particular not for a lumber company, with its capital necessarily largely invested in fixed assets. It would be an unreasonable interpretation to require instant liquidation in order to take advantage of the tax-free provision, for Congress did not anticipate the liquidation, but the continuance of corporate enterprises.

This is the more obvious from the fact that the act *in 1921* provided that the *March 1, 1913,* surplus

might then be distributed tax-free. Why should temporary fluctuations in position in 1915 and 1916 be deemed to have been important, when Congress in 1921 recognized the whole March 1, 1913, surplus, after the lapse of eight years, to be *then* distributable without tax? The opinion of the lower court therefore accords with actuality. The Commissioner ignores it.

8. The Commissioner asserts that the decision runs counter to his "settled and consistent administrative interpretation of the statute." If this be true (a matter we do not concede), still it is not the rule that an administrative official can by misinterpreting a statute bind the courts to his erroneous view. (*Burnet* v. *Chicago Portrait Co.*, 285 U. S. 1; 76 L. Ed. 359; 52 S. Ct. 275.) There is nothing to indicate that Congress was informed of his misinterpretation or ever considered the artificial issue which he has raised, apparently in the teeth of the simple, practical and evident meaning of the act. The cases have only reached the courts, so that until now there has been no reason why Congress should have considered the question at all. It plainly enough indicated its purpose and intent in the language it originally employed. The Commissioner has invented the issue in his favor from his views of bookkeeping instead of seeking to ascertain the intent of Congress from the act.

Respectfully submitted,

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